

No. 10087

**In the United States Circuit Court of Appeals
for the Ninth Circuit**

MINNIE L. WHITTHORNE AND EVA WHITTHORNE, EX-
ECUTRICES OF THE ESTATE OF W. R. WHITTHORNE,
DECEASED, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

and

SHERWOOD SWAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

SAMUEL O. CLARK, JR.,

Assistant Attorney General.

SEWALL KEY,

HELEN R. CARLOSS,

LOUISE FOSTER,

Special Assistants to the Attorney General.

FILED

SEP - 3 1942

PAUL M. TIERMAN,

CLERK

INDEX

	Page
Opinion below.....	1
Jurisdiction.....	1
Questions presented.....	2
Statute and regulations involved.....	2
Statement.....	2
Summary of argument.....	8
Argument:	
I. The Board correctly held that the taxpayers realized taxable gain in the taxable year from the settlement of certain debts by the payment of an amount less than the sums owed.....	10
(a) The taxpayers were solvent after the debt settlement and each had clear assets in excess of the amount of his cancelled debt.....	12
(b) The taxable gain received by the taxpayers upon settlement of their debts is measured by the amount of the debts cancelled.....	17
II. The Board properly determined the portion of the cost of the taxpayers' old stock which should be used as the cost basis of the new class A stock which they sold.....	20
III. The taxpayers are subject to a penalty for failure to file their tax returns in the time required.....	23
Conclusion.....	26
Appendix.....	27

CITATIONS

Cases:	
<i>Axton v. Commissioner</i> , 32 B. T. A. 613.....	21
<i>Baker v. Commissioner</i> , 115 F. 2d 987.....	23
<i>Collin v. Commissioner</i> , 32 F. 2d 753.....	23
<i>Commerce Trust Co. v. Woodbury</i> , 77 F. 2d 478, certiorari denied, 296 U. S. 614.....	13
<i>Commissioner v. Coastwise Transp. Corp.</i> , 71 F. 2d 104, certiorari denied, 293 U. S. 595.....	11
<i>Commissioner v. Simmons Gin Co.</i> , 43 F. 2d 327.....	11
<i>Commissioner v. Swenson</i> , 56 F. 2d 544.....	22
<i>Continental Bank v. Rock Island Ry.</i> , 294 U. S. 648.....	13
<i>Crowell v. Commissioner</i> , 62 F. 2d 51.....	23
<i>Curtiss v. Commissioner</i> , 57 F. 2d 847.....	23
<i>Dallas T. & T. Warehouse Co. v. Commissioner</i> , 70 F. 2d 95.....	11
<i>Edwards v. Grand</i> , 121 Cal. 254.....	25

Cases—Continued.

	Page
<i>Haden Co. v. Commissioner</i> , 118 F. 2d 285.....	11
<i>Helvering v. Amer. Chicle Co.</i> , 291 U. S. 426.....	10
<i>Houghton v. Commissioner</i> , 71 F. 2d 656.....	23
<i>Lakeland Grocery Co. v. Commissioner</i> , 36 B. T. A. 289.....	11
<i>Madison Railways Co. v. Commissioner</i> , 36 B. T. A. 1106.....	11
<i>McAlpine, J. K., Land & D. Co. v. Commissioner</i> , 126 F. 2d 163..	26
<i>Perkins v. Commissioner</i> , 33 B. T. A. 606.....	25
<i>Poynor v. Commissioner</i> , 81 F. 2d 521.....	25
<i>Salvage v. Commissioner</i> , 76 F. 2d 112, affirmed, 297 U. S. 106..	23
<i>Springfield Industrial Building Co. v. Commissioner</i> , 38 B. T. A. 1445.....	11
<i>United States v. Kirby Lumber Co.</i> , 284 U. S. 1.....	10
<i>United States v. Lombardo</i> , 241 U. S. 73.....	25
<i>Walker v. Commissioner</i> , 88 F. 2d 170.....	18
<i>Wells, Joseph S., Ass'n v. Helvering</i> , 71 F. 2d 977.....	16
<i>West Side Tennis Club v. Commissioner</i> , 111 F. 2d 6, certiorari denied, 311 U. S. 674.....	26
Statute:	
Revenue Act of 1936, c. 690, 49 Stat. 1648:	
Sec. 22.....	27
Sec. 53.....	27
Sec. 111.....	28
Sec. 112.....	28
Sec. 113.....	28
Sec. 291.....	29
Miscellaneous:	
Bouvier's Law Dictionary.....	25
T. D. 4871, 1938-2 Cum. Bull. 130.....	29
Treasury Regulations 94:	
Art. 22(a)-14.....	29
Art. 53-4.....	30
Art. 291-1.....	31

In the United States Circuit Court of Appeals for the Ninth Circuit

No. 10087

MINNIE L. WHITTHORNE AND EVA WHITTHORNE, EX-
ECUTRICES OF THE ESTATE OF W. R. WHITTHORNE,
DECEASED, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

and

SHERWOOD SWAN, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

ON PETITION FOR REVIEW OF THE DECISIONS OF THE UNITED
STATES BOARD OF TAX APPEALS

BRIEF FOR THE RESPONDENT

OPINION BELOW

The opinion of the Board of Tax Appeals (R. 76-90)
is reported in 44 B. T. A. 1234.

JURISDICTION

This review involves income tax and penalties for the
year 1936. (R. 91-92.) The Commissioner's de-
ficiency letter to each taxpayer¹ was issued October

¹ W. R. Whitthorne, who was the original taxpayer in the case
of *Minnie L. Whitthorne v. Commissioner*, died on July 25, 1940
(R. 78), while this case was still pending before the Board and
his executrices were substituted in that case, but throughout this
brief he will be treated as the taxpayer in that case.

20, 1939 (R. 18-19, 53-54), and a petition to the Board of Tax Appeals was filed by each on January 16, 1940, which was within the period allowed by Section 272 (a) (1) of the Internal Revenue Code. This review is taken from the Board's decisions in these cases entered October 2, 1941, allowing in the case of *Whittorne v. Commissioner* a deficiency of \$6,894.28 in income tax, plus a penalty of \$344.71 (R. 91), and in the case of *Swan v. Commissioner* a deficiency of \$38,687.37 in income tax, plus a penalty of \$1,934.37 (R. 92). The petitions for review by this Court were filed on December 26, 1941 (R. 93-104), pursuant to the provisions of Section 1141 and 1142 of the Internal Revenue Code.

QUESTIONS PRESENTED

1. Whether the taxpayers realized taxable gain from the cancellation of their debts during the taxable year and if so, whether such gain should equal the amount of the debts which were cancelled.

2. Upon the non-taxable reorganization of the Sherwood Swan & Company, Ltd., the taxpayers exchanged all of the old stock for all of the new preferred and common shares. The question is whether in determining gain realized thereafter from the sale of part of the new preferred stock the cost of the old stock should be partly allocated to the new common stock, as the Board found, or should be entirely allocated to the preferred stock, as the taxpayers contend.

3. Whether the taxpayers are subject to a penalty for filing their income tax returns one day after the end of the period allowed by the Commissioner for filing such returns.

STATUTE AND REGULATIONS INVOLVED

The statute and regulations involved are set forth in the Appendix, *infra*, pp. 27-31.

STATEMENT

The pertinent facts as found by the Board of Tax Appeals are as follows (R. 78-84):

W. W. Whitthorne and Sherwood Swan (who will be referred to herein as the taxpayers) were associated in business enterprises for many years. Among these was the operation of a market in Oakland, California, through Sherwood Swan & Company, Ltd., of which each taxpayer had acquired one-half of the outstanding 1,000 shares at a cost of \$50,000 (R. 78).

In March, 1930, the taxpayers were indebted to Harrison S. Robinson on their joint and several note for \$35,000, secured by the above stock. They were indebted to David S. Wasserman on their joint purchase money note for \$100,000, secured by 1,000 shares of Wasserman-Gattmann Company, one-half being owned by each. To the Central National Bank of Oakland they owed \$250,000 on their joint and several note secured by 6,000 shares of the Hale Brothers Stores, Inc. To the Bank of America they owed \$100,000 on their joint and several note, secured by 2,071 shares of the Hale Brothers Realty Company. To the Central National Bank, Swan alone owed an unsecured debt of \$20,000; and to the Bank of America he owed an unsecured debt of \$65,000 and a debt of \$10,000 secured by a mortgage on a ranch. (R. 78.)

Pursuant to an agreement between the taxpayers and the note holders on March 12, 1930, the two banks

paid off the taxpayers' note to Robinson and were later reimbursed therefor by the taxpayers. The taxpayers' shares which were pledged to Robinson were then released, and 500 were pledged with each bank but the banks agreed not to look to the securities thus pledged for more than \$100,000 each, and it was not the intention to cancel the debts in excess of that amount. (R. 78-79.)

On December 15, 1936, the taxpayers made an agreement with the receiver for the Central National Bank, then in receivership, by which the taxpayers agreed to pay in full settlement of their debts \$75,000 in cash and to give a noninterest bearing note for \$20,000 payable in installments. At that time the total original loans on which they were jointly indebted amounted to \$165,081.32, and Swan was individually indebted for \$20,000. There was also some accrued interest due. These debts were secured by various securities, but it was found that none of these, except the 500 shares of Sherwood Swan & Company, had any value. The latter were released to the taxpayers when the settlement was approved by the court. (R. 79-80.)

On December 16, 1936, the taxpayers were indebted to the Bank of America on a joint note amounting to \$89,066.33, and Swan owed \$65,000, which debts, together with accrued interest, aggregated \$196,073.14. On that date, these debts were settled by a pledge sale at which the taxpayers bid in the 500 pledged shares of Sherwood Swan & Company for \$100,000, and the Bank of America bid in the 2,071 shares of Hale Broth-

ers Realty Company, which had also been put up as security for part of the debts, for \$96,073.14. These shares were worth \$34,564.64. (R. 80.) ²

Upon the release of the 1,000 shares of the stock of Sherwood Swan & Company, they were placed with the trust department of the Anglo-California Bank, as the taxpayers had borrowed \$175,000 on December 15, 1936, from that bank. (R. 79, 81.)

After the settlement of their debts with the Bank of America and the Central National Bank, the taxpayers' liabilities were as follows (R. 81):

	Whitthorne	Swan
Joint note to Central Company, \$20,000.....	\$10,000.00	\$10,000.00
Note to Bank of America, secured by mortgage on Swan's ranch.....		10,000.00
Joint notes to Anglo-California Bank, \$175,000 and \$5,000.....	90,000.00	90,000.00
Note due David S. Wasserman.....		5,000.00
Accounts payable.....	1,500.00	15,571.60
Unpaid taxes.....		764.35
Total.....	101,500.00	131,335.95

On the same date each owned 500 old company shares. Whitthorne owned nothing else. Swan owned in addition a claim of \$9,835.12 against the old company and the mortgaged ranch, which had a value of \$6,000.³

² The Commissioner treated the payment as equalling only the actual value of the stock and so credited the taxpayers with a payment of \$34,564.69. (R. 21-23.)

³ But the evidence also shows that Whitthorne had an income of \$35 per week (R. 156) besides dividends from his stock, which it appears amounted to \$5,500 in 1936 and may not have been included in the Board's estimate of assets. Swan also had dividends in that amount and the consolidated balance sheet of the re-organized Sherwood Company indicates that on December 31, 1936, the company owed him \$16,182.23. (R. 219.)

After the settlement of the taxpayers' indebtedness to the banks, Whitthorne's assets exceeded his liabilities by at least \$35,040.66 and Swan's assets exceeded his liabilities by at least \$80,009.13. (R. 81.)

Pursuant to the agreement with the Anglo-California Bank under which the \$175,000 loan was made, the 1,000 shares of stock were surrendered and in a tax-free exchange the Sherwood Swan Company (new company) issued therefor 30,000 class A shares with a par value of \$10 each and 45,000 common shares of no par value, representing its entire capital stock. Each taxpayer received one-half of the new shares. On November 18, 1936, the taxpayers and Robert N. Miller & Company had made a contract contemplating this reorganization in which the former agreed to purchase 25,000 class A shares for \$175,000, or at \$7 each, plus accrued dividends from December 1, 1936, to date of actual delivery; to deposit \$25,000 and securities of a value of \$35,000 with the bank as trustee as security for payment of the price; and to pay \$24,500 to the trustee within three days after the shares should be available for delivery. (R. 81-82.)

During 1936, Miller & Company deposited the collateral, paid \$87,500 during December, 1936, and received 12,500 shares. The payment of the purchase price was completed by February 9, 1937, and the remaining 12,500 shares were delivered. After final payment the trustee delivered the 2,500 class A and 22,500 common shares remaining with him to each taxpayer. There has been no sale of common shares, but in 1937 Whitthorne transferred 4,500 to Swan, who agreed to

relieve Whitthorne of liability on their joint \$20,000 note due the Central National Bank. (R. 83.)

On December 31, 1936, the new company had assets of a book value of \$858,332.19. It had liabilities of \$370,661.74; a capital stock account of \$390,000, of which \$300,000 was allocated to the 30,000 class A shares and \$90,000 to the 45,000 common shares, and a book surplus of \$97,670.45. Land was carried among the assets at a book value of \$618,674.83. (R. 83.) In 1934, 1935 and 1936, the old company's net income and dividends were as follows (R. 83-84):

	1934	1935	1936
Net income.....	\$64,025.26	\$65,834.77	\$70,052.26
Dividends.....	12,000.00	32,000.00	11,000.00

The class A shares of the new company are entitled to cumulative preferential annual dividends of 60 cents a share and to a further participating dividend equal to any dividend declared or paid on the common shares for the same period after the common shares shall have received a dividend of 60 cents for that period. Holders of class A shares are entitled to one vote a share, and upon liquidation shall be preferred as to assets to the extent of \$10 a share plus accumulated and unpaid dividends. (R. 84.)

The taxpayers were granted an extension of time, expiring on June 1, 1937, for filing their income tax returns for 1936. An accountant employed by them completed preparation of the returns on May 29, 1937. The returns, properly signed and sworn to, were delivered

to the Collector. Swan's return is stamped by the Collector as filed on June 2, 1937. (R. 84.)

The Board held (1) that the Commissioner had correctly determined that taxable gain was realized upon cancellation of the taxpayers' debts in the amounts of \$80,009.14 and \$35,040.66 for Swan and Whitthorne, respectively; (2) that the basis used by the Commissioner in determining the gain on the sale of the stock was correct but that the gain should be reduced so as to be applicable only to the sale of 12,500 shares (which were delivered in 1936); and (3) that the taxpayers were liable for a penalty of 5% for failure to file their returns in time inasmuch as the evidence does not establish that the delay was due to a reasonable cause. (R. 90.)

Accordingly the Board decided that there is a deficiency in the case of *Minnie L. Whitthorne v. Commissioner* of \$6,894.24 in income tax and a penalty of \$344.71; and a deficiency in the case of *Sherwood Swan v. Commissioner* of \$38,687.37 in income tax and a penalty of \$1,934.36. (R. 91-92.)

SUMMARY OF ARGUMENT

1. It has been authoritatively established that a solvent taxpayer realizes taxable gain upon the cancellation of his debt for less than the sum owed. The Board found that the taxpayers here were solvent after the settlement of the debts which they owed two creditors and that they had clear assets in excess of the portions cancelled. As the evidence supports the Board's finding relative to solvency, the taxpayers have failed to

establish their contention that they were insolvent after the debt settlement.

Under the facts of this case, the taxable gain equals the amount of the debts cancelled. Thus the taxpayers are in error in urging that the measure of such gain should be the amount of the assets freed from a particular lien and in asserting that a considerable portion of the assets was freed from their debts in 1930 when the pledge of certain stock was given to their creditors. The fact that such pledge limited the amount which could be recovered from the pledged assets does not make the amount of gain less than the cancelled debt. It is true that taxable gain is realized because assets are freed when a debt is cancelled without the payment of any cash or property. But such freeing of assets is accomplished not by release from a special pledge but from the general burden of debt, and so the term "freed assets" means the amount of assets which constitute a taxpayer's surplus over liabilities, after cancellation of part of the latter.

2. The Commissioner determined that, in computing the gain realized by the taxpayers upon the sale of a portion of their new class A stock of Sherwood Swan Company, the cost of the old stock should be distributed between the class A stock and their new common stock. This determination was properly accepted by the Board inasmuch as the new stock was acquired as a result of a nontaxable exchange, and the evidence shows that the common stock, as well as the class A stock, had a market value. Consequently neither the facts here, nor the decisions support the taxpayers in contending that

the whole cost of the old stock should be allocated to the class A stock.

3. The Board correctly sustained the Commissioner's determination that the taxpayers are subject to a penalty of 5% for failure to file their returns on time since the evidence fails to establish that there was reasonable cause for the delay.

ARGUMENT

I

The Board correctly held that the taxpayers realized taxable gain in the taxable year from the settlement of certain debts by the payment of an amount less than the sums owed

The Commissioner determined that upon the settlement of the debts owed by the taxpayers to the Bank of America and the Central National Bank of Oakland, they realized taxable gain to the extent of the excess of the debts owed over the sums paid, or a gain of \$80,009.13 for Swan and of \$35,040.66 for Whitthorne. (R. 21-23, 56-58.) In approving the Commissioner's determination, the Board followed a rule which was first announced by the Supreme Court in *United States v. Kirby Lumber Co.*, 284 U. S. 1. In that case the taxpayer had issued its bonds at par and later purchased some of them at less than par. The Court held that the difference between par and the purchase price constituted income and so decided, in substance, that a taxpayer may realize taxable gain by settling his obligations for a sum less than their face amount. A similar conclusion was reached in *Helvering v. Amer. Chicle*

Co., 291 U. S. 426, and *Commissioner v. Coastwise Transp. Corp.*, 71 F. 2d 104 (C. C. A. 1st), certiorari denied, 293 U. S. 595. See also Article 22 (a)-14 of Treasury Regulations 94, Appendix, *infra*.

This principle is now generally accepted as applicable to the cancellation of any kind of indebtedness, but a number of cases have announced an exception to the rule. Thus, while there is nothing to indicate that the above decisions were dependent upon the debtor's solvency, and the net worth of a taxpayer is not a criterion in other kinds of cases for determining when taxable income is realized, yet it has been held that the above rule is applicable only when the debtor is solvent. *Dallas T. & T. Warehouse Co. v. Commissioner*, 70 F. 2d 95 (C. C. A. 5th); *Commissioner v. Simmons Gin Co.*, 43 F. 2d 327 (C. C. A. 10th); *Madison Railways Co. v. Commissioner*, 36 B. T. A. 1106; *Springfield Industrial Building Co. v. Commissioner*, 38 B. T. A. 1445. But this limitation on the general rule has been qualified by the holding that if a taxpayer becomes solvent upon the cancellation of his debt, he is taxable to the extent that his assets then exceeded his liabilities. *Haden Co. v. Commissioner*, 118 F. 2d 285 (C. C. A. 5th); *Lakeland Grocery Co. v. Commissioner*, 36 B. T. A. 289. Accordingly, under the present interpretation of this rule, we are required at the outset, in order to know if and how the rule is to be applied, to determine whether the taxpayers were solvent after the cancellation of their debts and to find out what were the amounts of their clear assets thereafter.

- (a) The taxpayers were solvent after the debt settlement and each had clear assets in excess of the amount of his cancelled debt

The Commissioner treated the taxpayers as solvent persons and the Board accepted this view, finding that after the debt settlement in 1936, each had clear assets in excess of the amount of his cancelled debt. Specifically, the Board found that the liabilities of Swan on December 16, 1936, after the settlement aggregated \$131,335.93 and that his cancelled debt amounted to \$80,009.13. Thus Swan's assets on that day would equal an amount in excess of the sum of these two items, or in excess of \$211,345.08. As to Whitthorne, the Board found that he had liabilities on that day of \$101,500, and that his cancelled debt amounted to \$35,040.66. Thus his assets would be an amount in excess of these two figures, or in excess of \$136,540.66. (R. 81.) The Board also indicated that there was nothing to show that either taxpayer was insolvent before the settlement. (R. 86.)

In denying their solvency the taxpayers do not discuss the Board's findings or even indicate that they are aware that findings of fact have been made against them, but, of course, to prevail here the taxpayers must show that the Board's findings are not supported by the evidence. At the hearing, the taxpayers introduced a statement as to Swan's assets which shows that after the settlement he had a net solvency of \$10,500.83. (R. 204). As to Whitthorne, the taxpayers do not contend that he was insolvent but assert that his net solvency was only \$3,500. (R. 86, Br. 31-32.) These figures were obtained by placing a value of \$105,000 on

the 500 shares of Sherwood Swan & Company, which constituted the assets of each. We shall discuss that valuation hereinafter and dispose first of taxpayers' alternative contention that in determining solvency the cost of such stock should be used as its value and hence that the net insolvency of each taxpayer was in excess of \$50,000. (Br. 27-28.)

We submit that in determining solvency there is no authority for using cost as the value of assets. It is apparent that the taxpayers here, as well as the Board, understand solvency to mean the presence of assets in an amount equal to, or in excess of, liabilities. This view is in accord with that taken in bankruptcy proceedings in which the term "insolvency" is defined as the financial status of a person whose assets, *at a fair valuation*, are not sufficient to pay his debts. *Continental Bank v. Rock Island Ry.*, 294 U. S. 648. This definition has also been adopted in some tax cases and is undoubtedly the sense in which the term "insolvency" is used in cases like the instant one. See *Commerce Trust Co. v. Woodbury*, 77 F. 2d 478 (C. C. A. 8th), certiorari denied, 296 U. S. 614; *Haden Co. v. Commissioner*, *supra*. It will be noted that this definition prescribes "a fair valuation" for assets, which obviously might be more or less than cost but should approximate the present worth of the assets after due consideration is given to all pertinent factors. The decisions cited by the taxpayers (Br. 25), in which fair market value where lower than cost is used, are not in conflict with this view but merely indicate that the actual value of assets at the time of the cancellation of

the debt is the one to be used. The taxpayers' objection to the use of fair market value higher than cost on the ground that it results in double taxation or causes a tax to be imposed on unrealized gain cannot be sustained but will be discussed below.

Thus, in determining solvency, we should apply the above definition and should accept the Board's finding here in regard to the amount of clear assets after the debt settlement, if supported by any substantial evidence. As the amount of the liabilities is not disputed and as the principal asset of each taxpayer, both before and after the settlement, was the stock of the Sherwood Swan Company, this point depends principally upon the evidence relative to the value of such stock, the entire issue of 1,000 shares (old stock) being held by the taxpayers, 500 shares each.

As we have indicated, under one of the taxpayers' estimates of their net worth, this stock was included at cost, which was \$100,000 for the 1,000 shares. (Br. 22-28.) But under another theory, which was also presented at the hearing, they value the stock at \$210,000 which they claim to be the fair market value. (Br. 31-32.) We submit that both figures are too low. The figure of \$210,000 was reached by multiplying the total number of class A shares received by them upon the reorganization (which was almost simultaneous with the debt settlement) by \$7, the price per share paid by the broker for a portion of such stock when it was turned over for resale to the public. (Br. 7.) In addition to the class A shares each taxpayer also received 22,500 shares of new common stock which the

Board found (R. 87) had substantial value, and which paid dividends for at least two years after its issuance. (R. 161.) Nevertheless in this estimate of their net worth, no value whatsoever is given to the new common stock. (R. 222.)

In this connection attention is also called to the fact that the \$210,000 estimate for the old stock is less than the amount for which it was pledged to the banks in 1930. As to this, the evidence shows that the stock was pledged for \$200,000 on the original loans made by the banks, plus \$35,000 for the Robinson loan assumed by the banks, and accrued interest on the latter amount. (R. 108.) It should be noted further that the parties then considered the amount of this pledge, which was in excess of \$235,000, as only a portion of the value of such stock, and this is still the view of the taxpayers for there are numerous references throughout their brief to their equity in such stock, which was, of course, the excess above the amount for which the pledge was given.

Inasmuch as the taxpayers owned all of the stock of Sherwood Swan & Company, it seems reasonable to hold that its value should approximate the net assets of the company, and there is support for such a view in the evidence. The assets of the new company were carried on its book on December 31, 1936, at \$858,339.17; its current and long term liabilities at \$370,661.74; its capital stock account at \$390,000 and its surplus amounted to \$97,670.45. (R. 83, 219.) It will be seen from these figures, that if the net assets, totalling over \$488,000, had been divided between the taxpayers they

would have each received over \$244,000, and we submit that it is not unreasonable to give each taxpayer's old stock a value which would approximate such a figure. This also appears to have been the opinion of the Board whose function it is to weigh the evidence.

In support of this view is the report of an engineer who made an appraisal of the property on December 14, 1936, in connection with the company's reorganization. He estimated its land, buildings and equipment to be worth \$710,000 at that time. This was not much smaller than the book value of such assets and in addition to this the company had other assets amounting to over \$115,000. (R. 152, 219.) Even the taxpayers' witnesses, who gave their opinion at the hearing as to the value of the company's land without improvements, estimated that the land by itself was worth around \$200,000 in 1936. (R. 135, 138.)

But perhaps a more important factor is that this company had been making money. During 1936, as well as in each of the two preceding years, it had a net income which it will be seen averaged about 8% of the book value of its total gross assets. Furthermore in each of those years and also for the two years succeeding 1936, the company paid dividends. (R. 83-84.) These are proper factors to consider in determining value. *Joseph S. Wells Ass'n v. Helvering*, 71 F. 2d 977 (App. D. C.).

The Board stated that it was not necessary for it to reach a definite value for this stock as the facts preclude a finding of insolvency, and it found that the clear

assets⁴ of the taxpayers after the settlement was in excess of the amounts of the debts cancelled. We submit that the evidence amply supports this conclusion and that the rule of the *Kirby* case and other similar cases is applicable here.

(b) The taxable gain received by the taxpayers upon settlement of their debts is measured by the amount of the debts cancelled

It is generally conceded that the principal reason for holding that a cancelled debt constitutes taxable gain is that there is a freeing of assets which the taxpayer has held and could have used to discharge his debts. But it should be evident that in using the term "freeing of assets", we are not referring to the release which occurs when a creditor agrees to limit his recovery on

⁴ To support the Board's finding, it is only necessary to show that after the settlement, Swan had assets in excess of liabilities (which amounted to \$131,335.95), plus \$80,009.13 (the amount of his debts which had been cancelled) or \$211,345.08 (R. 81).

In addition to the stock of Sherwood Swan & Company, which had a book value of about \$244,000, Swan's estimate (R. 203) shows a ranch valued at \$6,000 and current assets due from Sherwood Swan & Company of \$9,835.12 (but this is also given at \$16,182.23 at R. 219). Thus even at a valuation for stock, some lower than the above figure, Swan's total assets would still be in excess of \$211,345.08 and his clear assets in excess of the amount of the cancelled debt.

The same conclusion can be reached as to Whitthorne. His liabilities after the settlement amount to \$101,500, and his debts were cancelled to the extent of \$35,040.66. These items make a total of \$136,540.66, which would be the minimum value his gross assets could have in order to tax him on the amount of the debt cancelled, but as he also had stock with a book value of \$244,000, his clear assets would undoubtedly exceed the amount of his liabilities and leave more than the amount of the cancelled debt. (R. 81.)

a loan to a portion of the value of pledged assets and so in this technical sense releases the excess value to the debtor. After such release, the debtor would have just as much of debt as before. Consequently, the taxpayers are in error here in claiming that when their stock was pledged with the banks in 1930 for \$200,000, the excess was released within the meaning of the rule to be applied here and constituted income in that year. (Br. 19-21.) Thus while the banks could not force the taxpayers to pay anything from the stock above the amount for which it was pledged, such a release of their equity did not create income nor make the taxpayers any richer than they were before since their liabilities remained just as they were. In referring to this, the taxpayers state that the 1930 agreement with the banks "did not itself constitute a complete cancellation of any indebtedness" (Br. 17), but this is a misleading statement since none of the debts was cancelled in 1930. Furthermore the undisputed testimony shows that it was not then the intention of the parties to cancel any portion of such debts. (R. 118-120, 187.) Thus nothing happened in 1930 which could have resulted in taxable gain. Cf. *Walker v. Commissioner*, 88 F. 2d 170 (C. C. A. 5th).

The underlying theory of this case was well explained by the Board as follows (R. 87) :

A solvent taxpayer realizes a gain by a reduction of his debt irrespective of whether the debt is secured by a pledge or mortgage. The freeing of assets which has been regarded in the decisions as a significant fact is not the release of the pledged security from lien, but the effect of

enabling the debtor to use all his assets freed from the incubus of the debt. The obliteration of the offsetting liability for debt is what constitutes the gain. * * *

Accordingly, we submit that the situation here is not materially different from that in a case where there is no pledge of certain assets. Even though the banks did agree that they would restrict their recovery from the pledged stocks to a certain figure, this does not mean that the taxpayers could not, or did not, hold their equity in such stocks for the payment of any of their debts, including these to the banks; and there is nothing repugnant about such a suggestion for it may be properly assumed that a debtor intends to pay his debts and that he holds his assets for that purpose whether or not he can be compelled by his creditor to use particular assets for payment thereon. Moreover in setting up a proper balance sheet, these taxpayers must include all of their assets, as well as their liabilities, and only by offsetting the total assets against the total liabilities can they determine what, if any, surplus they have. Until the debts here involved were cancelled in 1936, they had to be included in the liabilities, and only when they were eliminated through cancellation was there a decrease in the total liabilities to be offset against the assets and a freeing of assets in a corresponding amount.

This being the theory underlying the applicable rule, it is clear that the imposition of a tax here does not result in double taxation. The taxpayers' contention (Br. 24-25) that it does, apparently assumes that this

tax is imposed on the value of the pledged stock which was released upon the debt-settlement in 1936 and later sold and that another tax being imposed on the gain from the sale would be on the same item. But it is obvious that the gain resulting from the cancellation of a debt is not a gain on any particular asset. Consequently, even though a taxpayer may have only one asset he will realize taxable gain twice, if he has any portion of his debts cancelled without payment, and if he sells such asset at a profit. The amount of the gain in each instance will, of course, not be the same ordinarily and will depend upon the facts of the two transactions, each being entirely distinct.

It is also erroneous to claim that the Government is trying to impose a tax on unrealized gain for it should be equally clear that gain from a cancelled debt is realized since thereafter the debtor actually has less of debt and more of assets than he had before. His gain is not comparable to the anticipated gain due to a rise in the value of property which being subject to fluctuation may never be converted into income.

II

The Board properly determined the portion of the cost of the taxpayers' old stock which should be used as the cost basis of the new class A stock which they sold

In connection with the reorganization of Sherwood Swan & Company in, December, 1936, the taxpayers surrendered their 1,000 shares of old stock and received in a nontaxable exchange 30,000 class A shares with a par value of \$10 and 45,000 common shares with no par value. (R. 82.) Through an agreement with a brokerage firm, 25,000 class A shares were to be sold

by the brokers to the public, with the latter paying the taxpayers \$7 per share. Under Section 113 (a) (6) of the Revenue Act of 1936 (Appendix, *infra*), the basis for determining gain on the sale of such new shares is the same as that for the old stocks, but the taxpayers now argue⁵ that the gain on the shares sold in 1936 should be computed by allocating the total cost of the old shares to the class A shares because the new common stock had no fair market value in December, 1936. In support of their contention, the taxpayers cite *Axton v. Commissioner*, 32 B. T. A. 613, but while the facts in that case are somewhat similar to those here, particular attention is called to the difference in the Board's findings in the two cases. In the *Axton* case, the Board made the specific finding that the new class B stock had no fair market value or any value on which a practicable allocation of the cost of the old shares could be made and so held that the whole cost should be assigned to the new shares.

But that is not the case here. The Board found in the instant case that the new common shares had substantial value, and that the Commissioner's distribution of 50.84% of the cost of the old shares to the class A stock, and 49.16% to the common, was a proper allocation and the best which the taxpayers could demand in view of the evidence showing the value of the company's

⁵ The taxpayers were first of the opinion that there should be an allocation. Thus, at the hearing the accountant who prepared the taxpayers' returns testified that he had allocated the cost of the old shares to both classes of new stock after considering earnings and book value of assets. (R. 164-165.) Swan also testified that he had considered their allocation of cost to both kinds of stock a fair one. (R. 153.)

assets, their earning power, and the ability to pay dividends on the common as well as on the class A stock. (R. 87, 89.) Consequently, the taxpayers here were first confronted with the Commissioner's determination, which was presumed to be correct until overcome by them but they failed in that burden (*Commissioner v. Swenson*, 56 F. 2d 544 (C. C. A. 5th)); and they are now confronted with the Board's finding of fact that the common stock had value.

In support of this finding, the record shows that in 1936, this company had a net income of about \$70,000. This would have been sufficient to pay the \$18,000 required for the preferential annual dividend of sixty cents on the 30,000 class A shares; and also enough to pay the \$27,000 needed to pay a sixty cents dividend⁶ on 45,000 common shares, and there would still have been \$25,000 of the net income remaining. The net income for earlier years approximated that for 1936, and dividends were not only paid for such years but for two years after 1936, dividends were paid on the new common stock. We submit that after giving due consideration to all the facts, the Board properly found that the common shares had substantial value and that the Commissioner had made a fair determination as to the allocation. There is no evidence that the stock could not have been sold if offered for sale, and the fact that no sale was made does not mean that it had no market

⁶ Common stock was entitled to such dividend after the same dividend had been paid on class A stock. Thereafter, the two kinds of shareholders got equal dividends. (R. 84.)

value. *Crowell v. Commissioner*, 62 F. 2d 51, 53 (C. C. A. 6th).

The practice of allocating cost of old stock to two classes of new stock has been approved in a number of cases involving facts similar to these here. See *Baker v. Commissioner*, 115 F. 2d 987 (C. C. A. 6th); *Salvage v. Commissioner*, 76 F. 2d 112 (C. C. A. 2d), affirmed on another issue, 297 U. S. 106; *Curtiss v. Commissioner*, 57 F. 2d 847 (C. C. A. 5th); *Houghton v. Commissioner*, 71 F. 2d 656 (C. C. A. 2d); *Collin v. Commissioner*, 32 F. 2d 753 (C. C. A. 6th). Accordingly such procedure is not novel, and it is not unfair to the taxpayers. Furthermore they have failed to sustain their burden as to this point.

III

The taxpayers are subject to a penalty for failure to file their tax returns in the time required

The taxpayers were granted two extensions of time for filing their tax returns for 1936, the last of which expired on June 1, 1937. Section 53 (2) of the Revenue Act of 1936 (Appendix, *infra*), authorizes the Commissioner of Internal Revenue to grant extensions under such regulations as he may prescribe. Article 53-4 of Treasury Regulations 94 (Appendix, *infra*), promulgated under that section, provides that the due date, when an extension has been granted, shall be the last day of the period covered by the extension. Thus, the taxpayers here were required to file their returns on June 1st.

As the returns were stamped by the Collector as being filed on June 2, 1937 (R. 84), the Commissioner added a penalty of 5% in accordance with Section 291 of the Revenue Act of 1936 (Appendix, *infra*), which provides for such penalty when no reasonable cause is shown for failure to file the return within the prescribed time. The Board sustained this penalty after finding that the evidence failed to establish that the delay was due to reasonable cause rather than to willful neglect. (R. 90.)

We submit that this is a proper finding. The accountant who prepared the returns for the taxpayers testified that he finished the returns on Saturday, May 29th, and turned them over to Swan (one of the taxpayers) on the morning of Tuesday, June 1st, which was the next business day (R. 168-169). Swan testified that what happened thereafter was "just a little bit hazy in my mind", but that he thought he took the returns to the office of the Internal Revenue Bureau in Oakland late that afternoon and, finding the office closed, slipped them through the slot in the door. However, Swan qualified this statement by explaining that he believed he did this because he had done so on one occasion and this might have been the time. (R. 179-180). Obviously, this evidence is too indefinite to rebut the filing date stamped on the returns by the Collector's office. Moreover, even if the returns were left at the Collector's office after hours on June 1st, such act would not constitute a filing on that date. A paper is not filed until it is delivered and received by the proper official

for filing. *United States v. Lombardo*, 241 U. S. 73, 76; *Poynor v. Commissioner*, 81 F. 2d 521 (C. C. A. 5th); Bouvier's Law Dictionary. Obviously, these returns were not received by any official on June 1st. Thus, this case is distinguishable from *Perkins v. Commissioner*, 33 B. T. A. 606, cited by the taxpayer, for in that case there was definite evidence that the returns had been delivered during office hours to the proper official, and that the Collector had inadvertently stamped the filing date as the following day. However, in the absence of positive evidence, as in the instant case, the Collector's stamp must be treated as conclusive.

The case of *Edwards v. Grand*, 121 Cal. 254, which the taxpayer also cites, is not in point even if a state decision can be treated as controlling. The question there was which of two instruments should be given precedence, and it was decided that the one which was delivered first to the recorder at his office, although delivery was made after office hours and actual filing occurred the subsequent morning. The other paper had been handed to the recorder the next morning on the way to his office with directions for filing. This case cannot be treated as authority for holding that a federal tax return which was not handed to any official on the date for filing, but was merely left at the office after hours, was filed within the meaning of the revenue statute.

Accordingly, June 2nd must be accepted as the date of filing and as no reason whatsoever was offered for the delay, the penalty is mandatory. Such holding is

in accord with this Court's decision in regard to the same penalty in *J. K. McAlpine Land & D. Co. v. Commissioner*, 126 F. 2d 163. Also see *West Side Tennis Club v. Commissioner*, 111 F. 2d 6 (C. C. A. 2d), certiorari denied, 311 U. S. 674.

CONCLUSION

The Board's decision should be affirmed as to all issues.

Respectfully submitted.

SAMUEL O. CLARK, JR.,
Assistant Attorney General.

SEWALL KEY,
HELEN R. CARLOSS,
LOUISE FOSTER,
*Special Assistants to the
Attorney General.*

AUGUST 1942.

APPENDIX

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. * * *

* * * * *

SEC. 53. TIME AND PLACE FOR FILING RETURNS.

(a) *Time for Filing.*—

(1) *General Rule.*—Returns made on the basis of the calendar year shall be made on or before the 15th day of March following the close of the calendar year. Returns made on the basis of a fiscal year shall be made on or before the 15th day of the third month following the close of the fiscal year.

(2) *Extension of Time.*—The Commissioner may grant a reasonable extension of time for filing returns, under such rules and regulations as he shall prescribe with the approval of the Secretary. Except in the case of taxpayers who are abroad, no such extension shall be for more than six months.

(b) *To Whom Return Made.*—

(1) *Individuals.*—Returns (other than corporation returns) shall be made to the collector

for the district in which is located the legal residence or principal place of business of the person making the return, or, if he has no legal residence or principal place of business in the United States, then to the collector at Baltimore, Maryland.

* * * * *

SEC. 111. DETERMINATION OF AMOUNT OF, AND RECOGNITION OF, GAIN OR LOSS.

(a) *Computation of Gain or Loss*.—The gain from the sale or other disposition of property shall be the excess of the amount realized therefrom over the adjusted basis provided in section 113 (b) for determining gain * * *.

* * * * *

SEC. 112. RECOGNITION OF GAIN OR LOSS.

(a) *General Rule*.—Upon the sale or exchange of property the entire amount of the gain or loss, determined under section 111, shall be recognized, except as hereinafter provided in this section.

* * * * *

(3) *Stock for Stock on Reorganization*.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

SEC. 113. ADJUSTED BASIS FOR DETERMINING GAIN OR LOSS.

(a) *Basis (Unadjusted) of Property*.—The basis of property shall be the cost of such property; except that—

* * * * *

(6) *Tax-free Exchanges Generally.*—If the property was acquired, after February 28, 1913, upon an exchange described in section 112 (b) to (e), inclusive, the basis (except as provided in paragraph (15) of this subsection) shall be the same as in the case of the property exchanged, decreased in the amount of any money received by the taxpayer and increased in the amount of gain or decreased in the amount of loss to the taxpayer that was recognized upon such exchange under the law applicable to the year in which the exchange was made. * * *

* * * * *

SEC. 291. FAILURE TO FILE RETURN.

In case of any failure to make and file return required by this title, within the time prescribed by law or prescribed by the Commissioner in pursuance of law, unless it is shown that such failure is due to reasonable cause and not due to willful neglect, there shall be added to the tax: 5 per centum if the failure is for not more than thirty days with an additional 5 per centum for each additional thirty days or fraction thereof during which such failure continues, not exceeding 25 per centum in the aggregate. The amount so added to any tax shall be collected at the same time and in the same manner and as a part of the tax unless the tax has been paid before the discovery of the neglect, in which case the amount so added shall be collected in the same manner as the tax. The amount added to the tax under this section shall be in lieu of the 25 per centum addition to the tax provided in section 3176 of the Revised Statutes, as amended.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 22 (a)–14.¹ *Cancellation of indebtedness.*—The cancellation of indebtedness, in whole

¹ This article was amended by T. D. 4871, 1938–2 Cum. Bull. 130, in a respect not material here.

or in part, may result in the realization of income. If, for example, an individual performs services for a creditor, who in consideration thereof cancels the debt, income in the amount of the debt is realized by the debtor as compensation for his services. A taxpayer realizes income by the payment or purchase of his obligations at less than their face value. (See article 22 (a)-18.) If a shareholder in a corporation which is indebted to him gratuitously forgives the debt, the transaction amounts to a contribution to the capital of the corporation. * * *

* * * * *

ART. 53-4. *Due date of return.*—The due date is the date on or before which a return is required to be filed in accordance with the provisions of the Act or the last day of the period covered by an extension of time granted by the Commissioner or a collector. When the due date falls on Sunday or a legal holiday, the due date for filing returns will be the day following such Sunday or legal holiday. If placed in the mails, the returns should be posted in ample time to reach the collector's office, under ordinary handling of the mails, on or before the date on which the return is required to be filed. If a return is made and placed in the mails in due course, properly addressed and postage paid, in ample time to reach the office of the collector on or before the due date, no penalty will attach should the return not actually be received by such officer until subsequent to that date. If a question may be raised as to whether the return was posted in ample time to reach the collector's office on or before the due date, the envelope in which the return was transmitted will be preserved by the collector and forwarded to the Commissioner with the return. As to additions to the tax in the case of failure to file return within the prescribed time, see section 291.

* * * * *

ART. 291-1. *Addition to the tax in case of failure to file return.*—In case of failure to make and file a return required by Title I within the prescribed time, a certain percent of the amount of the tax is added to the tax unless the return is later filed and failure to file the return within the prescribed time is shown to the satisfaction of the Commissioner to be due to reasonable cause and not to willful neglect. * * *

* * * * *

A taxpayer who files a tardy return and wishes to avoid the addition to the tax for delinquency must make an affirmative showing of all facts alleged as a reasonable cause for failure to file the return on time in the form of an affidavit which should be attached to the return. If such an affidavit is furnished with the return or upon the collector's demand, the collector, unless otherwise directed by the Commissioner, will forward the affidavit with the return, and, if the Commissioner determines that the delinquency was due to a reasonable cause, and not to willful neglect, the addition to the tax will not be assessed. If the taxpayer exercised ordinary business care and prudence and was nevertheless unable to file the return within the prescribed time, then the delay is due to a reasonable cause.

* * * * *

